rates."[57] "Because such rates would overall be lower than the generally averaged rates," they would, "by definition, be just and reasonable, as long as they are above the carrier's relevant costs."[58]

Some parties, including AT&T, argue that such pricing flexibility will allow the LECs to discriminate on behalf of their long distance affiliates.[59] But such unfounded fears do not provide a justification to deny customers the benefits of allowing LECs to offer flexible pricing. LECs are already barred from discriminating in favor of their long distance affiliate by the Act and by Commission rules.[60] Moreover, as the Commission has recently recognized, pricing discrimination "is relatively easy for [the Commission] and others to detect, and is therefore unlikely to occur."[61]

Similarly, permissive deaveraging will not result in unreasonable price discrimination. Allowing permissive rate deaveraging will "enhance economic efficiency" by allowing LECs to compete for customers that they can serve more efficiently than their rivals.[62] Indeed, if the Commission does not allow deaveraging, it will force customers in high density areas with more competition

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[57] AT&T Petition at 7.

[58] AT&T Petition at 8, n. 7.

[59] *See* AT&T at 81, MCI at 59-63; Sprint at 38, 41; WorldCom at 20-22.

[60] *See* Crandall Reply Affidavit at ¶ 22.

[61] ***Applications of Pacific Telesis Group and SBC Communications for Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries***, Report No. LB-96-32, Memorandum Opinion and Order, ¶ 53 (rel. Jan. 31, 1997).

[62] Affidavit of Robert W. Crandall at ¶ 21, attached as Exhibit 1 to the Joint Comments.

into a choice between paying higher rates or abandoning the LEC.[63] Moreover, customers in areas of lower density and relatively less competition would still be protected -- both through the price cap mechanism which would limit how much rates are deaveraged, and through the market. In any given area, regardless of the level of competition, if LECs price too high, they will attract new competitors using unbundled network elements.

A few parties make the circular argument that because LECs have not used all of the very limited flexibility LECs have been given to date, they should be given no additional flexibility. Such a claim misses the point -- more pricing options are needed to allow LECs to respond to individual market conditions. For example, Bell Atlantic has not used the available deaveraged rate zones because they fail to reflect the level of actual competition.[64] In contrast, where the Commission has given flexibility on an exception basis to match competitive market conditions, as it has for NYNEX in LATA 132, LECs have relied on that flexibility to adjust prices.[65] In addition, LECs have made extensive use of the pricing flexibility associated with discounts for Special Access and Switched

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[63] *See* Crandall Reply Affidavit at ¶ 21.

[64] Indeed, competitors have collocated with Bell Atlantic facilities in zone 3 areas. The problem is compounded by the requirement that transport between zones be priced at the level of the higher priced zone. If the zones do not reflect actual competitive patterns, there is more likely to be transport that crosses a zone boundary and thereby loses any pricing flexibility.

[65] NYNEX has already targeted more than $60 million in annual reductions to transport interconnection charges in LATA 132, and it has an application on file for permission for similar rate changes in LATA 128.

Transport services, which are not as restrictive as the zone pricing rules. The IXCs have shown significant demand for these discount plans, which have reduced the overall cost of access. Such flexibility must be the rule and cannot be restricted to limited flexibility on an exception basis.[66]

B. Services Should Be Removed from Price Caps As Soon As A Competitive Alternative is Available. (Paras. 161-162, 164-167, 201-217)

As soon as a LEC makes a showing that customers for one or more of its services have a competitive alternative available, these services must be removed from the Part 69 rate structures and price cap regulation altogether. As Bell Atlantic and NYNEX demonstrated, it is the presence of a competitive alternative, and not historical measures of market share loss, that reflect the true market check on pricing.[67] While AT&T and other parties argue otherwise, AT&T's own economic witnesses go even further and argue that once entry barriers are down, even ***potential*** competition can "effectively constrain market power."[68] As a result "even when only one firm is present" in a market with low

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[66] Indeed, in addition to requiring a great deal of work by NYNEX and the Commission, the waiver process for LATA 132 took a year and a half to obtain regulatory approval for part of the pricing flexibility requested. NYNEX filed its petition for waiver on December 13, 1993. The FCC did not issue an order until May 4, 1995 (10 FCC Rcd 7445 (1995)).

[67] ***See*** Joint Comments at 56.

[68] Citizens for a Sound Economy Foundation at 7 (quoting W. Baumol, J. Panzar and R. Willig, "Contestable Markets and the Theory of Industry Structure," Harcourt Brace Jovanovich (1982)).

entry barriers, "antitrust and regulatory attention" can become "unnecessary."[69] Given the Act's opening of the local exchange and access markets, entry barriers have been removed. Thus, any competitor actively offering service is clear evidence that there is no need for further regulatory price restrictions.[70]

IV. Price Levels Should Be Addressed In The Context Of Price Caps. (Paras. 1-54, 161-217)

A decision by the Commission to adopt a market-based approach that provides an opportunity for LECs to recover their actual costs does not mean that access rates will not be lowered as a result of access reform. In fact, access rates will be reduced in at least four ways. First, under the access reform proposals of NYNEX and Bell Atlantic, per-minute interstate access charges will be substantially reduced. By reducing the variable cost of access, this will create

[69] ***Id.***

[70] The American Petroleum Institute ("API") cites Bell Atlantic's antitrust action against Lucent as support for its argument that a single competitor is insufficient to allow pricing freedom. API at 18. But Bell Atlantic's suit recognizes that unlike the markets here, the market for switch manufacturing has high entry barriers that limit competition. ***See Bell Atlantic Corp. v. AT&T Corp.,*** Complaint at ¶ 22, (Feb. 14, 1996) (attached to API's comments).

new incentives for more economic utilization of the network.[71] It will also create an immediate rate reduction for high volume access customers. Second, a market based approach will facilitate fair competition, which, in and of itself, will have the greatest impact in driving total rates down. If the Commission allows the market forces unleashed by the interconnection and unbundling requirements of the Act to operate, the impact on rates will be dramatic. Third, the restructure of rates to better reflect cost causation will remove the per-minute growth from the CCL and most of the TIC recovery. Since usage growth has historically exceeded line growth by a substantial margin, flat-rate recovery will reduce the overall charges to the IXCs as compared to per-minute recovery. Fourth, the price cap annual productivity adjustment will reduce regulated rates. Until specific services have a competitive alternative available, they will continue to be regulated by the price cap mechanism. Using a productivity offset that

[71] Of course, those incentives will be undermined if the IXCs fail to pass through access reductions to their customers. As LECs have shown, the IXCs did not pass along access charge reductions in the past unless required to do so by Commission rule. *See* "Critique of MCI White Paper," attached to USTA Reply Comments. The Commission should read the fine print before accepting current IXC "commitments" to pass through access charges at face value. MCI only promises to pass along the savings to customers "when the overcharges for access are abolished." It is not clear whether access reform that reduced some, but not all, of what MCI defines as "overcharges" would be passed along. MCI at 6. Similarly, AT&T's statement that it will pass along access charge reductions "as we've done in the past" (*see* Telecommunications Reports, February 10, 1997, p. 11) is not reassuring given its past behavior.

reflects achievable productivity gains, price cap regulation will continue to guarantee annual reductions in real access rates.

Relying on market forces in conjunction with price cap regulation will permit the Commission to oversee these rate reductions, while allowing appropriate investment incentives to continue. The Commission will undercut the benefits of price cap regulation, however, if it allows the continuation of productivity offsets that overstate true industry productivity growth. "The fundamental principle of price cap regulation is that increased efficiency is most surely generated by profit incentives; where the LECs have the ability to spur higher productivity, they should be given a fair incentive to do so."[72] In order to provide the LECs a "fair incentive," the Commission has recognized that it should strive to set a productivity offset that best predicts future industry productivity. Because the current offsets overstate achieved or achievable industry productivity, they must be reduced. As NYNEX and Bell Atlantic demonstrated in their initial comments, the price cap goals can best be achieved here by setting a fixed productivity factor based on a five year average of total

[72] ***Policy and Rules Concerning Rates for Dominant Carriers***, 5 FCC Rcd 6786, 6794 (1990) ("Price Cap Order").

factor productivity adjusted for the downward impact on future productivity of moving the CCL and TIC away from usage-based rates to flat rate recovery.[73]

Not satisfied with the real price reductions guaranteed under an economically justified productivity offset, the IXCs repeat refuted arguments in order to support the highest productivity offset imaginable. Underlying the IXC arguments is an effort to get a second bite at the TELRIC apple. If the Commission recognizes, as it must, that it cannot cut rates to a level that would deny the LECs an opportunity to recover their actual costs, then the IXCs ask the Commission to accomplish the same result through an oversized productivity offset. But characterizing a price cut as part of price cap regulation changes nothing. It would be arbitrary and capricious for the Commission to use the price cap mechanism merely as a rate cutting tool without underlying economic justification.[74]

For example, AT&T continues to support its so-called "performance based model." This model has been demonstrated to be error filled and fundamentally

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[73] *See* Joint Comments at 58-60; L. Christensen, P. Schoech and M. Meitzen, "Updated Results for the Simplified TFPRP Model and Response to Productivity Questions in FCC's Access Reform Proceeding," at 8-9, Attachment 5 to USTA Comments.

[74] "[R]easoned decisionmaking" requires specific justification of rates including analysis of the substantive record. ***Aeronautical Radio v. FCC***, 642 F.2d 1221, 1231 (D.C. Cir., 1980).

flawed.[75] Rather than measure actual productivity, as Dr. Christensen does, the AT&T model "is just a dressed-up version" of rate of return regulation.[76] As such, it relies on "arbitrary cost allocation, depreciation, and other regulatory standards" to reduce access rates to the "point that their regulatory accounting rates of return equal their prescribed economic cost of capital."[77]

AT&T also argues that its proposal to remove SLC charges from price caps would result in an increase in achievable productivity.[78] AT&T's claim is that the network supporting the remaining price capped services will have higher

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[75] ***See*** Affidavit of Dr. James H. Vander Weide in Support of Reply Comments of the United States Telephone Association at ¶¶ 6-8 (originally filed in CC Docket 94-1, Mar. 1, 1996 ("Vander Weide Price Cap Affidavit"), Attachment 9 to USTA Reply; Declaration of Melvyn A. Fuss (originally filed Mar. 1 as an attachment to Bell Atlantic Reply Comments in CC Docket No. 94-1 and attached hereto as Exhibit 2); Declaration of Melvyn A. Fuss dated May 31, 1996, originally filed as Bell Atlantic ***Ex Parte*** Letter filing from Joseph J. Mulieri in CC Docket 94-1 (filed June 4, 1996), attached hereto as Exhibit 3; Christensen Associates, "Critique of the AT&T Performance Based Model" (Attachment 6 to USTA Comments).

[76] Vander Weide Price Cap Affidavit at ¶ 8.

[77] ***Id.*** Despite some IXCs' apparent desire to rely on rate of return concepts when it suits them, it is not at all clear that rate of return regulation would support a reduction in LEC access rates. Achieved economic rates of return are far below 11.25%. ***See*** Affidavit of Dr. James H. Vander Weide in Support of Comments of the United States Telephone Association at 5 ("Vander Weide Affidavit"), Attachment 4 to USTA Comments. Moreover, even accounting rates of return, which overstate true economic results, do not support dramatic cuts in access rates. For example, Bell Atlantic's most recent regulatory accounting interstate rate of return is 10.6% (for Jan.-Dec., 1996).

[78] AT&T at 71. In its supporting materials AT&T also argues that the current level of LEC stock prices is evidence that access prices are too high. AT&T Comments, Exhibit B at 18. This is nonsense. As AT&T is well aware through its own divestiture, stock prices reflect expectations about all aspects of a firm's business, including, for the large LECs, unregulated businesses.

productivity than the network supporting the SLC. This argument is based on AT&T's own flawed assumption that it is possible to calculate productivity of individual services that rely on a shared network. In fact, AT&T assumes a nonexistent relationship between the growth in revenues and the growth in costs. AT&T's assumptions effectively preordain AT&T's desired result -- a higher productivity growth level for price capped services. As several experts have demonstrated, such assumptions render AT&T's conclusion "economically meaningless."[79]

Other parties, including MCI, would not only push the Commission back toward discredited rate of return regulation, but also argue that rates should be represcribed based on a lower cost of capital benchmark.[80] By setting rates based on costs rather than price and productivity, any such represcription would in itself be an abandonment of price cap regulation and would undermine the incentive for continuation of the benefits lauded by the Commission.[81] Regardless, economic data suggests that no change in the cost of capital is warranted.[82] Moreover, even assuming the economic cost of capital were as low

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[79] L. Christensen, "Best Basis for Determining the Rate of LEC TFP Growth," attached to USTA Reply Comments. ***See also*** affidavits cited in Footnote 75.

[80] ***See*** MCI at 18-24.

[81] ***See*** Joint Comments at 7.

[82] ***See Price Cap Performance Review for Local Exchange Carriers,*** CC Docket 94-1, Affidavit of James H. Vander Weide at 25, attached to Bell Atlantic Reply Comments (filed June 29, 1994) (calculating that an updated cost of capital would be slightly greater than 11.25%).

as the 10% MCI claims, which it is not, LEC economic rates of return -- the only comparable measure for an economic cost of capital -- are even below that level.[83]

V. The Rate Structure For Access Charges Should Reflect The Manner In Which Costs Are Incurred. (Paras. 55-139)

While most commenters agree that access reform should result in rates that reflect the way that costs are incurred, there is a wide variety of proposed alternatives to the current access charge regime. Most commenters recognize that the current carrier charges, which are primarily applied on a usage basis, do not reflect the nontraffic-sensitive nature of most of the underlying costs.[84] In addition, there is a need to reduce the level of usage-based access charges due to the arbitrage problem created by the availability of low-priced UNEs, which can be recombined to bypass LEC access charges. Therefore, many commenters suggest alternative rate structures that would convert certain per-minute charges to flat rate charges that would be paid by end users, IXCs, or both.

Carrier Common Line Charge. Most commenters agree that the carrier common line ("CCL") charge should be converted to a per-line charge, since the underlying loop costs are nontraffic sensitive.[85] The main point of disagreement is whether the per-line charge should be recovered from the end user via an

[83] *See* Vander Weide Affidavit at 5.

[84] *See* Ad Hoc at 7-8; Ameritech at 9; NARUC at 12-14; RTC at 6-7; USTA at 55-56; ALTS at 26; GSA at 7-12.

[85] *See, e.g.,* AT&T at 51-54; GTE at 24-26; Missouri PUC at 2-3; California PSC at 3; Florida PSC at 2; Alabama PSC at 4; NARUC at 3.

increase in the end user common line ("EUCL") charge, or from the IXCs through a charge per-presubscribed line ("PSL").[86] Bell Atlantic and NYNEX favor a PSL charge, because policy considerations have impeded increases in the EUCL charge in the past, and because an increase in this charge could be perceived as contrary to the expected effects of the Telecommunications Act of 1996. In addition, the IXCs would have alternative means of recovering PSL charges, such as using fixed minimum monthly charges, tapered per-minute charges, or other mechanisms.[87]

The Commission should reject arguments that the Act does not allow these costs, which are associated with the end user line, to be recovered from the IXCs.[88] The fact that these costs are nontraffic sensitive, and are incurred as a result of an end user's decision to purchase a telephone line, does not determine to which jurisdiction the cost should be assigned, or who should pay them. Subscriber loops are used to provide both local and long distance service, and IXCs use the loop as an "input" to their long distance service. Therefore, it is appropriate for the Commission to continue to assign a portion of these costs to the interstate jurisdiction and to allow the LECs to recover them from the IXCs.

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[86] ***Compare*** AT&T at 53; TCI at 9-10; Sprint at 10-13; ***with*** SCA at 16-21; SNET at 32-33; US West at 53.

[87] **See, e.g.**, SCA at 24; BellSouth at 68-69; CPUC at 4; NECA at 10-12; Pacific at 64; Texas PUC at 4-5; WorldCom at 33. Some IXCs may also decide not to pass along PSL costs directly to the end user in order to obtain a marketing advantage.

[88] ***See, e.g.,*** AT&T at 52-53.

Moreover, the Commission should recognize that the IXCs have various options for passing along these costs to the end user or for absorbing them as the competitive market dictates. It should be noted that the IXCs will pay no more as a result of the restructuring of common line charges than they pay today. Therefore, most IXCs may not have any need to modify their long distance rates simply because the CCL charge is converted to a flat rate.

Local Switching Rates. Most commenters recognize that there is a nontraffic sensitive component in local switching costs associated with subscriber line ports and carrier trunk ports.[89] However, many commenters agree with Bell Atlantic and NYNEX that, for administrative reasons, the Commission should not prescribe flat-rated elements to recover these costs.[90] It may be difficult to quantify the nontraffic sensitive portion of switch costs, and it may be administratively cumbersome to separately charge for trunk ports based on the type of transport used by an IXC. The Commission should allow the LECs the flexibility to develop flat-rated charges for port costs if they want to develop the appropriate cost support.

Transport Services. As could have been expected, the commenters took different views of what a cost-based structure for switched transport services

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[89] *See, e.g.,* ACTA at 7; ALTS at 26; MCI at 79-82; TCG at 21-22.

[90] *See, e.g.*, USTA at 57; SNET at 8. There is also a concern that it would be difficult for the LECs to develop cost support for peak/off-peak pricing of local switching. *See, e.g.,* MCI at 83. The Commission should not mandate such pricing, but leave it as an option for a LEC.

should look like, generally in line with the positions that they took in the Local Transport Restructure in Docket 91-213. AT&T argued for an unbundled structure consisting of (1) flat-rated charges for direct-trunked transport between an end office or a tandem office and a serving wire center; (2) flat-rated charges for entrance facilities; and (3) per-minute, per-mile charges for tandem-switched transport, based on the airline mileage between an end office and a tandem switch.[91] CompTel argued for continuation of the existing "unitary" rate structure, under which tandem-switched transport is provided at a per-minute, per-mile rate measured by the airline mileage between the end office and the serving wire center.[92]

The Commission should recognize that the existing rate structure for Local Transport services was largely a compromise designed to avoid significant changes in the costs of transport services to large vs. small IXCs.[93] This rate structure does not reflect the way that costs are incurred, and it does not provide for competitive neutrality.

The current structure ignores the actual configuration of LEC facilities where the end office, the tandem office, and the serving wire center are not in a straight line. For example, in the diagram on page 15 of the Notice, the sum of the distances between (1) the end office and the tandem office; and (2) the

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[91] *See* AT&T at 59-60.
[92] *See* CompTel at 24-27.
[93] ***See Transport Rate Structure and Pricing,*** 7 FCC Rcd 7006, 7040-42 (1992).

tandem office and the serving wire center, is greater than the distance from the end office to the serving wire center. The current rules require the LEC to price tandem switched transport based on the airline distance between the end office and the serving wire center, in the same way as dedicated transport would be priced between those two points.

The problem with this approach is that it puts a competitive access provider ("CAP") that is collocated at the tandem office, and that is providing transport services to the IXCs in competition with the LEC, at a disadvantage in competing for dedicated transport services from the tandem office to the serving wire center of the IXC's point of presence. The CAP would have to pay the LEC for the end office to tandem office transport and try to recover its own costs for the additional mileage from the tandem office to the serving wire center, in competition with LEC rates that are based on direct airline mileage from the end office to the serving wire center. In addition, a CLEC that constructs its own tandem-switched network, and that might have a more efficient configuration than the LEC network, is unable to take advantage of those efficiencies, because the LEC prices its tandem-switched transport without regard to the actual routing of traffic. It also hurts the LEC, because the cost of the additional mileage is buried in the transport interconnection charge ("TIC"), which makes the LEC's usage-based switched access charges less competitive.

Even if tandem-switched transport were based on actual route mileage between the end office and the serving wire center, it would not be cost-based, because the facilities between the tandem office and the serving wire center are dedicated to a particular IXC. Both the LEC and the CAP provide transport facilities between a tandem office and a serving wire center based on the type and quantity of facilities ordered by the IXC, and without regard to the amount of traffic over those facilities. Therefore, it does not make economic sense to require the LEC to make these facilities available to an IXC on a per-minute basis, as is required by the current rate structure rules for tandem-switched transport.

To promote competitive equality, the Commission should allow the LECs to charge rates for tandem switched transport based on the actual mileage between end office, tandem office, and serving wire center. Also, it should allow the LECs to recover 100 percent of tandem switching costs from the tandem switching charge, rather than 20 percent as allowed by the Commission's rules. When the LEC restructures its transport rates under the new rules, the difference in revenues that would be generated from the transport rate elements should be used to reduce the TIC.

Transport Interconnection Charge. The TIC is the most controversial rate element, as the IXCs generally argue for either its immediate or eventual elimination, while the LECs explain that the TIC revenues represent real costs

IXCs. Thus, they should be able to recover these costs from their current long distance rates without a general rate increase.

VI. Conclusion

For the foregoing reasons, the Commission should adopt a more cost-based rate ***structure*** for switched access services, but it should deal with the ***level*** of access charges, including a reduction in the annual productivity factor, in the context of its existing price cap system.

Respectfully submitted,

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Dated: February 14, 1997

CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of February, 1997 a copy of the foregoing "Joint Reply Comments of Bell Atlantic and NYNEX" was served by hand on the parties on the attached list.

Tracy M. DeVaux

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Reply Affidavit of Robert W. Crandall

Qualifications

1. I am a Senior Fellow in Economic Studies at the Brookings Institution.[1] I have been asked by Bell Atlantic and Nynex to respond to some of the points raised by AT&T and MCI in their comments in this matter. My qualifications and Vitae were in my affidavit filed earlier in this proceeding.

Summary and Conclusions

2. In my affidavit appended to the Bell Atlantic/Nynex comments in this proceeding, I pointed out that any change in the structure of interstate access charges must be evaluated in terms of efficient pricing (and, therefore, cost causation), incentives for productive efficiency and investment, and recovery of the incumbent LECs' costs. I concluded that the Commission's proposed market-based approach, combined with a restructuring of access charges to reflect cost causation, was the best regulatory strategy for achieving all of these goals through the Commission's price-cap regulation.

[1]The views expressed herein are my own and should not be taken to represent the views of the Brookings Institution, its other staff members, or its Trustees.

3. In their comments, AT&T and MCI argue for a prescriptive approach that would immediately and perhaps even repeatedly recalibrate carrier access charges to estimates of forward-looking costs. Their approach is in essence a repudiation of price caps and the substantial efficiency improvements attained during the seven years of price-cap regulation of the LECs.

4. The Commission should not risk sacrificing the benefits that price caps have induced. The structure of incumbent rates should be altered to reflect cost causation, but this restructuring should not place the price-caps regime in danger. Price caps not only provide incentives for incumbent LECs to pursue efficiency improvements and network investment, but they provide entrants with greater assurances against anticompetitive cross-subsidization by incumbent carriers. Were the Commission to return after seven years to setting individual components of access rates at some estimate of costs, as AT&T suggests, the Commission's price-cap regime would become worthless. Price caps are a replacement for cost-based regulation; they cannot function with a cost-based "recalibration" of rates.

5. AT&T and MCI also recommend against allowing incumbent LEC various forms of price flexibility in pricing interstate access services until there is demonstrated, vibrant facilities-based access competition in their regions despite the fact that such flexibility is likely to be efficiency-enhancing in any conditions. The fears expressed by these commenters that the incumbent LECs are likely to use such authority for rate flexibility in an anticompetitive fashion

are overstated. The incumbent LECs cannot use rate flexibility for self-dealing under the Commission's rules, and they would not succeed in using it for anticompetitive purposes given the sophistication of the buyers of access services and the very large resources of their likely competitors in local access markets -- namely, AT&T and MCI.

The Regulation of Interstate Access Services

6. The incumbent LECs' interstate access services are now provided at rates that are regulated by the Commission under a price-cap regime. This regulatory approach was begun in 1990 after decades of cost-based, rate-of-return regulation that was specifically designed to recover an increasing share of the LECs' costs from interstate sources.[2] At no time, were the LECs free to exercise market power in setting these rates; they are not free to do so today; and they will not be free to exercise "monopoly" power in establishing these rates under any of the alternatives proposed by the Commission in this proceeding. If current rates do not reflect the costs of individual access elements, it is because of regulatory decisions to require the LECs to recover costs in this fashion.

7. One must distinguish between the structure and the level of current access rates. I agree with AT&T and MCI that the current structure of access rates is inefficient because it does not

[2]This policy has been well understood for more than a decade. See, for example, Congressional Budget Office, The Changing Telephone Industry: Access Charges, Universal Service, and Local Rates. Washington, 1984.

reflect cost causation. This structure must be changed so that the price of interstate usage does not reflect the major nontraffic sensitive costs of the network. Once this is done, the Commission may wish to address the level of the LECs' interstate rates by reassessing the manner in which network costs are assigned to the interstate jurisdiction under its separations policy. As long as the LECs' interstate rates are regulated and required to recover the current interstate allocation of network costs, the regulatory regime must be structured so that rates remain compensatory. The level of the LECs' overall interstate rates was never intended simply to reflect the costs of the services purchased by interexchange carriers; thus, all reference to these rates as "monopoly" rates or "excess consumer charges."[3] is mere rhetoric. These rates are the result of a regulatory decision to recover costs in this fashion.

Market-Based Versus Prescriptive Regulation

8. The Commission has proposed two very different approaches to reforming the method of regulating the incumbent LECs' interstate services. Both approaches anticipate a restructuring of rates to reflect cost causation, but they differ as to the approach for establishing the rates of the restructured interstate elements. The market-based approach would allow entry by facilities-based carriers and carriers purchasing unbundled network elements, combined with the inexorable downward pressure from price caps, to move rates from the levels that result from just

[3]These assertions appear repeatedly in the AT&T comments. See AT&T Comments at 5, 14, 30, 35, and 43. See also MCI Comments at 19-20.

the restructuring of access charges. The other, prescriptive approach would establish, and perhaps even continually recalibrate rates for individual access elements at some forward-looking estimate of costs while at least attempting to recalibrate and extend the price-cap regime.

9. In my original affidavit in this proceeding, I endorsed the market-based approach because it was most likely to preserve the salutary effects of price caps. Moving to a cost-based "prescriptive" approach would compromise the entire price-cap regime. While I agree with AT&T and MCI that a reduction of usage charges for interstate access will provide a large net gain in economic welfare, reverting to cost-based regulation in setting each and every element of access rates would largely vitiate the efficiency-enhancing effects of price caps. Even though AT&T cites one of my recent publications in arguing for such cost-based regulation, I have not, in fact, advocated a return to cost-based regulation.[4] It is relatively easy to observe that rates

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[4] See, Robert W. Crandall and Leonard Waverman, Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications, Brookings, 1996, Chapters 4 and 8. AT&T's cites a recent publication by Jerry Ellig and me (Economic Deregulation and Consumer Choice: Lessons for the Electric Utility Industry (The Center for Market Processes, George Mason University, 1997), suggesting that we claim that rate rebalancing could reduce the "social costs" of the inefficient system of access charges by as much as $45 billion per year. (AT&T Comments at 3) While I agree that the current system is highly inefficient and that a rebalancing of rates could generate enormous gains in economic welfare, we did not assert that the current interstate access charge system generates as much as $45 billion in "social costs." Rather, citing recent research by Leonard Waverman and myself (Talk is Cheap), we suggest that consumers could gain as much as $45 billion per year in benefits from a full rebalancing of intrastate and interstate rates to cost. The Crandall and Waverman study shows that the cost-based rates that achieve this result would reduce carrier welfare by $15 billion per year; hence, the net welfare improvement would be $30 billion per year, assuming that Crandall-Waverman's cost estimates are accurate and that rates could somehow be set equal to these costs. However, Crandall and Waverman do not advocate cost-based regulation as the mechanism to obtain these gains or any portion thereof.

equal to those established through competition are likely to be more efficient than those that have emerged from more than 60 years of regulation, but the Commission's task in prescribing such a result through cost-based regulation is much more difficult. Had cost-based regulation been the answer, the Commission might have achieved this desirable result during the decades of cost-based regulation up to 1990. In fact, the Commission abandoned cost-based regulation of the incumbent LECs in 1990 precisely because it was convinced that price caps provided a better set of incentives for the LECs to pursue cost minimization.

10. The Commission's price-cap regime has been quite successful. Indeed, the comments of AT&T and MCI suggest that price caps have been successful far beyond anyone's initial expectations. Despite the fact that rates have been consistently reduced by a price-cap formula that requires a substantial productivity dividend, both assert that the incumbent LECs could now be required to reduce rates substantially to reflect the efficiency improvements achieved under price caps. AT&T argues that the Commission should reduce the incumbent LECs' annual interstate switched access rates by $10.6 billion, from $12.2 billion to $1.6 billion.[5] It then suggests that the incumbent LECs should be able to recoup $4 billion through the Universal Service Fund and potentially be able to make a case for recouping another $5.3 billion in end-user charges.[6] This would leave at least $1.3 billion of unrecoverable costs that presumably reflect the efficiency gains achieved during the price-cap regime. (Rates were based on carrier

[5]AT&T Comments at 34.

[6]Id.